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In the Supreme Court of the United States

OCTOBER TERM, 1940

No. 2

NEW WORLD LIFE INSURANCE COMPANY, PETITIONER

v.

THE UNITED STATES

ON WRIT OF CERTIORARI TO THE COURT OF CLAIMS

BRIEF FOR THE UNITED STATES

OPINION BELOW

The opinion of the court below (R. 32–60) is reported in 26 F. Supp. 444.

JURISDICTION

The judgment of the court below was entered on March 6, 1939. (R. 60.) A motion for a new trial was overruled on May 29, 1939. (R. 60.) The petition for a writ of certiorari was filed on September 25, 1939, the time for filing having been extended by order of this Court. (R. 70.) The petition for a writ of certiorari was denied Novem-

ber 22, 1939. (R. 70.) Petitioner's time for filing a petition for a rehearing on its petition for a writ of certiorari was extended until March 15, 1940, by an order entered on December 18, 1939. The petition for rehearing was filed on March 4, 1940. On May 20, 1940, the Court entered an order granting the petition for a writ of certiorari, limited to the second question presented thereby, and vacated the order denying certiorari entered on November 22, 1939. (R. 70.) On September 21, 1940, respondent filed a motion to dismiss the writ of certiorari. This motion was denied October 14, 1940. The jurisdiction of this Court rests on Section 3 (b) of the Act of February 13, 1925, as amended by the Act of May 22, 1939.

QUESTIONS PRESENTED

1. Whether the writ of certiorari in this case should be dismissed.

2. Whether a life insurance company is entitled to a deduction under Section 203 (a) (2) of the Revenue Acts of 1928 and 1932 on account of reserve funds held by it with respect to health and accident insurance which it had issued in conjunction with its life insurance.

STATUTES AND REGULATIONS INVOLVED

The pertinent portions of the applicable statutes and Treasury Regulations are set forth in the Appendix, *infra*, pp. 49–61.

STATEMENT

This suit was instituted by the petitioner to recover income taxes with respect to the calendar years 1929–1932, inclusive. The sole item for which petitioner sought refund related to the propriety of certain deductions for investment expenses.[1] That issue was decided against petitioner and this Court has refused to grant certiorari to review it. However, in defending this suit, the Government contended in the alternative that even if petitioner were otherwise entitled to a refund with respect to its investment expenses such refund could not be had in this case because petitioner had underpaid its taxes with respect to a wholly different item during those years, namely, that it had improperly taken deductions on account of its reserves for health and accident insurance.

The decision of the Court of Claims in the Government's favor on the investment expense issue made it unnecessary for the court to consider also the affirmative defense based on the reserve deduction. The court nevertheless did undertake to consider the reserve issue as well, and decided that issue for the Government. The writ issued by this Court was limited to the reserve question, and the

[1] Taxpayer's complaint originally sought refund with respect to two other items for the years 1931 and 1932 (R. 9, 13), but those items were eliminated from the case as a result of certain concessions made by each side (see Finding 9 (d), R. 21; Finding 12 (d), R. 23).

facts found by the court below (R. 17–32), relating to that question may be summarized as follows:

The taxpayer is a stock life insurance company organized under the laws of the State of Washington, and during the years 1929 to 1932, inclusive, and prior thereto, was engaged in the business of issuing and selling life insurance in Washington and other states of the United States on the level-premium plan. (R. 17.) Some of its life insurance policies contained additional provisions of total and permanent disability benefits—that is, health and accident insurance. (R. 17.) The mean of the reserve funds held by the taxpayer for the fulfillment of its life insurance contracts constituted an average of approximately $7,500,000, and of its health and accident policies an average of approximately $195,000 for the years involved herein. (R. 17–18.) It issues separate policies of life insurance, but its health and accident insurance is issued only in a combined policy of life, health and accident insurance. It sells no other kind of insurance. (R. 18.)

A sample policy containing the additional provisions for health and accident insurance is reproduced in the record. (R. 61–67.) Page 6 thereof (R. 66) contains the entire contract in respect to health and accident insurance. If that page were removed, the remainder of the policy would be the usual complete form of a life insurance policy only. The premiums for the health and accident insur-

ance are shown separately on page 6 of the sample policy (R. 66), and the total premiums shown on the face of the policy (R. 61) constitute the premium paid for the life insurance, the disability insurance, and the accident insurance (R. 26, 66). The premium paid for the life insurance constitutes the amount shown on the face of the policy (R. 61) less the premiums charged for disability and accident insurance shown on page 6 of the policy (R. 66). The policyholder may discontinue the disability and/or accident insurance without affecting the life insurance, and without affecting the life insurance premium. (R. 26.) The disability and accident benefits are not included in any paid-up term insurance, or other paid-up benefits granted upon the surrender or lapse of the policy; nor does any reserve held on account of the disability and accident insurance enter into the amount of the reserve held on account of the life insurance covered by the policy, or the surrender, cash, or loan value shown in the "Table of Loan and Non-forfeiture Values." (R. 26, 64.)

The taxpayer issues its life insurance contracts, as well as its contracts for disability insurance, on what is commonly known as the level-premium plan. (R. 27.) It creates and maintains a reserve out of the premiums received for the life insurance coverage and also creates and maintains a separate reserve out of the premiums received for the total and permanent disability benefits coverage.

(R. 27.) In respect of any policy in force which also provided for disability and/or accidental death benefits, the taxpayer at all times set up and maintained a life reserve in the same manner as if the policy had been issued without such disability and/or accidental death provisions. (R. 27.) Its outstanding assurance obligations applicable to life insurance were valued upon the basis of the American Experience Table of Mortality, with interest at 3½ percent, as required by the laws of the states in which it did business, and it maintained reserves therefor as thus calculated. (R. 27.) It deducted the statutory percentage of the mean of such life insurance reserves for each of the years involved from gross income, and there is no controversy here with respect thereto. (R. 27.)

In respect of any combined life, health and accident insurance policies in force, in addition to its reserves with respect to the life insurance coverage, the taxpayer also set up and maintained, out of the total and permanent disability premiums, reserves with respect to the total and permanent disability benefits covered by such policies. (R. 27.) These latter reserves fall into two classes, to-wit: Reserve for Active Lives, and Reserve for Disabled Lives. (R. 28–29.) The Reserve for Active Lives is established at the time the policy is issued, and relates to outstanding disability insurance on which disability has not occurred.

(R. 29.) This reserve is computed in accordance with standard combined mortality and disability tables, with interest rates as required by the laws of the states in which the taxpayer does business. (R. 29.) If and when a person carrying disability insurance becomes totally and permanently disabled, the taxpayer transfers a certain amount of the reserve for Active Lives to the reserve for Disabled Lives. (R. 29.) The amount so transferred is calculated upon the basis of selected tables of probabilities of length of disability and expected benefits (such as Hunter's Disabled Lives Mortality Table), plus an assumed rate of interest (usually 3½ per cent compound interest). (R. 29–30.) This calculation also takes into consideration the mortality element, as well as the indefiniteness of the period during which the disability benefits must be paid, since the disability payments cease upon the death of the disabled person, or upon the discontinuance of his disability. (R. 30.)

In its tax returns for the years involved, the taxpayer took deductions under Section 203 (a) (2) on account of the reserves held by it for Total and Permanent Disability Benefits arising under the disability provisions of its combined life, health and accident policies, both in respect to Active Lives and Disabled Lives. (R. 29–30.)

The court below ruled that no deductions should have been taken by petitioner under Section 203

(a) (2) with respect to its reserves for health and accident insurance. However, since the Government was not seeking any deficiency with respect thereto, the judgment of the Court of Claims denying petitioner a refund on account of the investment expense issue did not reflect its decision on the reserve question.

SUMMARY OF ARGUMENT

I

This suit was brought by petitioner in the Court of Claims to recover income taxes for the years 1929–1932, claiming that it had overpaid its taxes for those years as a result of being denied a certain deduction on account of investment expenses. The Government defended, first, on the ground that petitioner was not entitled to that deduction, and, second, that even if petitioner were entitled to that deduction, any possible refund arising therefrom would be offset by petitioner's underpayment of taxes in those years with respect to a wholly different item: namely, that petitioner had improperly taken deductions with respect to its health and accident reserves.

The Court of Claims held that petitioner was not entitled to the investment expense deduction. That holding completely disposed of the entire case before the court: it determined that petitioner was not entitled to the refund which it sought. But the Court of Claims went further and decided, secondly, that,

in any event, petitioner would not be entitled to a refund because it had in fact underpaid its taxes by taking unauthorized deductions on account of its health and accident insurance reserves.

This Court, in granting the petition for certiorari, limited the writ to the second issue. But it is plain that, since petitioner is in no event entitled to any refund, the second issue is moot at this stage of the proceedings. Nothing that this Court could decide with respect to that second issue, whether for or against the Government, could in any way affect the "no refund" judgment of the court below.

The fact that the same issue may be involved in later tax years is no reason to render a decision upon the issue here, where such decision could not possibly affect the result in this case. The existence of such a controversy with respect to later years may perhaps convert an otherwise moot case into a "case" or "controversy" in the constitutional sense and thereby justify, constitutionally, a declaratory judgment with respect thereto. But the Judicial Code has been specifically amended to remove all federal tax questions from the scope of the Declaratory Judgments Act, and thus forbids any mere declaration of rights with respect to federal taxes where "further relief" cannot be given.

Nor is the result any different by reason of the possible suggestion that a decision on the reserve issue here would be *res judicata* as to future years. The short answer is that the discussion of the Court of

Claims with respect to the reserve issue would not be *res judicata* as to later years. Moreover, it is doubtful, even if the reserve question had been squarely in issue in the court below, whether a decision on an unmixed question of law in a controversy involving one tax year would be *res judicata* in cases subsequently arising with respect to later tax years.

II

In any event, petitioner is not entitled, under Section 203 (a) (2), to any deduction on account of its reserves for health and accident insurance.

Beginning with the Revenue Act of 1921, life insurance companies were specially classified. A life insurance company pays no taxes with respect to profits derived from the insurance business as such, *i. e.*, it is not taxable upon underwriting income or earned premiums. Nor is it taxable with respect to profits obtained upon the sale or disposition of any of its assets. Its taxable income is narrowly limited to include only "interest, dividends, and rents" (Section 202 (a) of the 1928 and 1932 Acts), sometimes referred to as investment income. And it is allowed deductions on account of expenses, etc., which relate to the production of such investment income. But in addition to the favorable treatment thus far accorded to a life insurance company, it is given an artificial deduction of unusual magnitude, namely, "An amount equal to * * * 4 [3¾ under the 1932 Act] per centum of the mean of the reserve funds required by law

and held at the beginning and end of the taxable year * * *" (Section 203 (a) (2)).

It is our contention that such unusually favorable treatment was intended to apply only to *life insurance* reserves, and not to reserves for health and accident insurance. An insurance company, other than a life insurance company, is given no such deduction on account of health and accident insurance, and there is no reason to believe that Congress intended to grant such deduction to life insurance companies. Indeed, the legislative history discloses quite the contrary.

Nor is there any sound reason for distinguishing between health and accident insurance sold separately and the same insurance when sold in conjunction with life insurance. Actuarially, there is no difference whatever. The reserves for health and accident insurance are separately computed, and are wholly distinct and independent of life insurance reserves. A separate premium is charged for the health and accident insurance. And it is customary to permit the owner of a "combined" policy to discontinue the health and accident insurance at any time without affecting in the least his contract of life insurance.

The decisions of this Court make it plain that the reserve deduction must be narrowly limited to life insurance reserves. In *Helvering* v. *Illinois Ins. Co.*, 299 U. S. 88, 90, this Court stated that "The phrase 'required by law' includes only reserves that directly pertain to life insurance.

Other reserves, even though required by state statutes regulatory of the business authorized to be carried on by life insurance companies, are not included." See also *Helvering* v. *Inter-Mountain Life Insurance Co.*, 294 U. S. 686.

In any event, to the extent that the reserves relate to policies where the disability has already occurred (reserves for "Disabled Lives"), the deduction is not available to petitioner. Such reserves are comparable to reserves for unsettled loss claims and are plainly not life insurance reserves.

Administrative practice under Section 203 (a) (2) has not been uniform. The early practice was to allow the deduction which petitioner now claims. But the Treasury had long been in doubt as to the correctness of that practice, and, following this Court's decisions in the *Inter-Mountain* and *Illinois Life* cases, it eliminated its earlier ruling from the regulations. Such change in regulations was certainly appropriate prospectively (*cf. Helvering* v. *Wilshire Oil Co.*, 308 U. S. 90), and was equally valid as to pending cases since the prior regulations were not in harmony with the decisions of this Court relating to reserves (cf. *Manhattan Co.* v. *Commissioner*, 297 U. S. 129, 134–135). Therefore, since the earlier practice was not in accord with the correct construction of the statute, such a change in practice is not forbidden by *Helvering* v. *Reynolds Tobacco Co.*, 306 U. S. 110. But even

if the *Reynolds* decision be thought to be a bar, we believe it to have been incorrectly decided, and, for reasons set forth at length in the body of this brief, we ask that it be reexamined.

ARGUMENT

I

THE WRIT OF CERTIORARI SHOULD BE DISMISSED, BECAUSE THIS CASE DOES NOT PRESENT ANY QUESTION THAT MAY BE REVIEWED IN THIS COURT

1. The Government renews its contention, made in the motion to dismiss, that this case presents no question that can be decided here.

This suit originated as a proceeding before the Court of Claims to recover income taxes for the years 1929–1932. After certain preliminary concessions, both by the Government and the taxpayer, the sole ground of recovery for all of those years was petitioner's claim that it had overpaid its taxes by being denied a full deduction for that portion of its officers' salaries which it allocated to "investment expenses". The Court of Claims, construing Section 203 (a) (5) of the applicable revenue acts, held that there had been no overpayment. The decision on that issue completely disposed of the only item of taxes for which petitioner sought refund. However, as an affirmative defense, the Government had undertaken to show that even if petitioner were entitled to a refund with respect to the investment expense issue, it had nevertheless

underpaid its taxes for the years in question by improperly taking deductions on account of its health and accident reserves. The statute of limitations had already run, so that the Treasury was without power to assess any deficiency with respect to the reserve deduction, but it was still open to the Government to show, defensively, that the petitioner had in fact underpaid its taxes and thus offset any possible overpayment by the taxpayer on the investment expense item. *Lewis* v. *Reynolds*, 284 U. S. 281.

Since the court below decided the investment expense issue in the Government's favor, it was therefore unnecessary for it to pass upon the affirmative defense. It nevertheless did consider that issue, and likewise decided that question in favor of the Government.[2]

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[2] The court below was apparently under a misapprehension that the issue was not entirely defensive, and that petitioner was in fact seeking refund with respect to the reserve issue, as well as the investment expense issue, for the years 1931 and 1932. See R. 47. The court's error lies in the fact that it misunderstood the stipulation of the parties, incorporated into the findings, to the effect that "the Commissioner disallowed" part of the reserve deduction for the years 1931 and 1932 (R. 21, 23). The court apparently thought that such "disallowance" resulted in payment of taxes by the petitioner for which it would be entitled to obtain a refund if the deduction were proper. But petitioner had paid no taxes whatever with respect to that item. The "disallowance" was merely in an audit by the Commissioner, after the statute of limitations had run on the years in question, and the disallowance therefore did not result in any payment by petitioner with respect to the reserve issue. This is made

This Court denied the petition for certiorari to the extent that petitioner sought review of the investment expense issue, but granted certiorari on the reserve issue. But since petitioner's only ground for refund was decided against it below and since this Court has denied certiorari on that question, it is clear, as well as undisputed, that no judgment for refund of any kind could be entered in petitioner's favor, regardless of how this Court might decide the reserve issue. That issue is moot at this stage of the litigation, and the writ should therefore be dismissed.

2. Petitioner's only apparent reason for urging that the issue is not moot is its assertion that the same issue is involved in later tax years, and that a decision by this Court on the issue would determine its tax liability with respect to this issue for such later years. But even assuming that the existence of the issue in later years could convert the otherwise moot issue into a "case or controversy" in the constitutional sense, any judgment entered by this Court could not affect the "no refund" judgment of the court below. If this Court should assume jurisdiction to decide the reserve issue, it

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abundantly clear by Exhibit B to the stipulation of facts which the Court of Claims adopted by reference in its findings (R. 23), but which was omitted from the printed record in this Court by agreement of the parties (R. 69). However, Exhibit B is properly before this Court, and clearly shows that petitioner would not in any circumstances be entitled to a refund on account of the reserve issue. We do not understand petitioner to assert the contrary.

could at most enter a declaratory judgment. But Congress has specifically withdrawn from the courts the power to enter declaratory judgments in federal tax cases. Section 405 of the Revenue Act of 1935 (c. 829, 49 Stat. 1014), carefully amended the Declaratory Judgments Act to remove from its scope controversies with respect to federal taxes. Section 405 provides as follows:

> SEC. 405. DECLARATORY JUDGMENTS AS TO TAXES.
>
> (a) Paragraph (1) of section 274D of the Judicial Code (Public, Numbered 343, Seventy-third Congress) is amended by adding after the words "actual controversy" the following: "(except with respect to Federal taxes)".

And Section 274D (1) of the Judicial Code, as amended by the foregoing provisions, now reads as follows:

> In cases of actual controversy (except with respect to Federal taxes) the courts of the United States shall have power upon petition, declaration, complaint, or other appropriate pleadings to declare rights and other legal relations of any interested party petitioning for such declaration, whether or not further relief is or could be prayed, and such declaration shall have the force and effect of a final judgment or decree and be reviewable as such.

In essence, since petitioner could not be entitled to "further relief", it is asking the Court to "de-

clare rights" within the meaning of the foregoing provisions. Yet the amendment to those provisions has made it plain that the validity of federal taxes is to be determined only in cases where they are actually involved and where a judgment affecting specific liability with respect thereto may be entered in response to the pleadings.

3. Moreover, even apart from the statutory provisions relating to declaratory judgments, petitioner has not presented an issue which this Court should decide. In *California* v. *San Pablo &c. Railroad*, 149 U. S. 308, the narrow issue before the Court had become moot, but counsel urged that the case be decided for they had entered into a stipulation that several other pending cases would be governed by the outcome of that case. This Court nevertheless held that since a decision on the merits could not affect the result in that case, the writ of error had to be dismissed. The Court stated (p. 314):

> The duty of this court, as of every judicial tribunal, is limited to determining rights of persons or of property, which are actually controverted in the particular case before it. When, in determining such rights, it becomes necessary to give an opinion upon a question of law, that opinion may have weight as a precedent for future decisions. But the court is not empowered to decide moot questions or abstract propositions, or to declare, for the government of future cases, principles or rules of law which can-

> not affect the result as to the thing in issue in the case before it. No stipulation of parties or counsel, whether in the case before the court or in any other case, can enlarge the power, or affect the duty, of the court in this regard.

Compare *Barker Co.* v. *Painters Union,* 281 U. S. 462; *South Spring Gold Co.* v. *Amador Gold Co.,* 145 U. S. 300. But cf. *So. Pac. Terminal Co.* v. *Int. Comm. Comm.,* 219 U. S. 498.[3]

4. Nor is the situation any different by reason of the possible suggestion that a decision on the reserve issue would be *res judicata* as to future tax years, and that the issue should therefore be decided here. The short answer to such circular reasoning is this: if the Court should dismiss the writ because the issue is moot or because of the provisions of the declaratory judgment statute, then the decision on the reserve issue would not be be *res judicata* as to future years. And if any doubt exists as to this, the order of the Court dismissing the writ, or an opinion of the Court accompanying the order, could so state.

Moreover, it is doubtful whether a decision on a pure question of law is *res judicata* between the

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[3] To be contrasted with the *So. Pac. Terminal Co.* case, however, is *United States* v. *Anchor Coal Co.,* 279 U. S. 812, where the Court, of its own motion, noted at the argument that the case had become moot by reason of expiration of the controverted order of the Interstate Commerce Commission. Counsel for both sides filed a brief relying upon the *So. Pac. Terminal Co.* decision and asking for an adjudication on the merits, but the Court nevertheless dismissed the appeal.

parties as to future tax years, not yet litigated. Suppose, for example, that the New World Life Insurance Company had actually paid taxes and sought a refund with respect to the reserve deduction; and suppose further that it had not petitioned for certiorari from an adverse decision of the Court of Claims construing the statute so as to deny the deduction. Then, if this Court should decide in a case involving another taxpayer, say the Pan-American Life Insurance Company, that the statute should be construed to permit the deduction, it would be harsh, indeed, to hold that the New World Life Insurance Company would be denied the deduction for all later years in perpetuity.[3a]

The term *res judicata* has been used loosely in tax cases. The traditional application of the doctrine of *res judicata* would forbid the reopening of a decision with respect to the tax year that had been litigated. But the doctrine has been extended in tax cases to embrace the same issue for future years not yet litigated. The general theory is

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[3a] The situation here is much stronger against the application of *res judicata* because the discussion of the Court of Claims on the reserve issue was entirely unnecessary to the decision.

A somewhat analogous situation might be presented in a case where review is sought in this Court of a decision of a state court that could be rested either upon a federal or non-federal ground. This Court normally declines to review such cases. Would the situation be different if the parties were to suggest that the federal ground might be controlling as *res judicata* in some possible future litigation that perhaps could not be rested upon a non-federal ground?

sound. Thus, if the March 1, 1913, value of property for the purpose of depreciation has been judicially established in a proceeding involving one tax year, the basic principles underlying *res judicata* would forbid relitigating that issue even as to a future year, and even though one side or the other has new evidence to offer. But those same principles should have no bearing where there is involved an unmixed question of law.[4] Cf. *United States* v. *Moser*, 266 U. S. 236, 241–242.

The absurd results that would flow from the application of the doctrine of *res judicata* to pure question of law in controversies not yet in litigation, or perhaps not yet arisen, is readily apparent from the example discussed above. And this Court has already indicated that the traditional concept of *res judicata* must give way in tax cases to a realistic view where it is sought to project the doctrine of *res judicata* to govern liability for future tax years. Cf. *Blair* v. *Commissioner*, 300 U. S. 5.

II

A LIFE INSURANCE COMPANY IS NOT ENTITLED TO ANY DEDUCTION UNDER SECTION 203 (A) (2) ON ACCOUNT OF RESERVES FOR HEALTH AND ACCIDENT INSURANCE

In the event that the Court should conclude that the reserve question is properly in issue here, we

[4] *Tait* v. *Western Md. Ry. Co.*, 289 U. S. 620, apparently involved issues of fact as well as law. In that case there was an unsuccessful attempt to show facts in the new proceeding that were said to be different from certain facts stipulated in the first proceeding. Pp. 625–626.

contend that the deductions taken by petitioner should have been denied.[5]

2. *Introductory.* Prior to the enactment of the Revenue Act of 1921, life insurance companies were taxed as ordinary corporations upon their full income.[6] Beginning with the 1921 Act, however, an entirely new system of taxation was inaugurated. Insurance companies were classified in three groups: (1) life insurance companies, (2) insurance companies other than life or mutual, and (3), mutual insurance companies other than life. The same classification obtains in the statutes here involved, the Revenue Acts of 1928 and 1932.[7] Under the new scheme of taxation, a life insurance company is no longer taxed upon its full income, and is accorded unusually favorable treatment as contrasted with the tax burdens imposed upon other corporations. It pays no taxes upon profits realized in carrying on the life insurance business as

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[5] The decision of the court below in this respect is in conflict with three circuit courts of appeals decisions now before this Court: *Helvering* v. *Pan American Life Insurance Co.*, No. 264; *Helvering* v. *Oregon Mutual Life Insurance Co.*, No. 564; and *Helvering* v. *Monarch Life Insurance Co.*, pending on extension of time for application for ceriorari.

[6] Corporation Excise Tax Act of 1909, c. 6, 36 Stat. 11, 112; Revenue Act of 1913, c. 16, 38 Stat. 114, 166; Revenue Act of 1916, c. 463, 39 Stat. 756; Revenue Act of 1918, c. 18, 40 Stat. 1057.

[7] Life insurance companies are taxed under Sections 201–203 of the Revenue Acts of 1928 and 1932; insurance companies other than life or mutual are taxed under Section 204 of these acts; and mutual insurance companies other than life are taxed under Section 208. See Appendix, *infra*.

such; *i. e.*, it is not taxable upon underwriting income or on earned premiums. Moreover, it is not liable for taxes on profits derived through the sale or disposition of any of the numerous assets which it necessarily owns. Its taxable income is narrowly limited to include only "interest, dividends, and rents" (Section 202 (a) of the 1928 and 1932 Acts), sometimes referred to as investment income. In the circumstances, of course, available deductions from gross income have likewise been limited more or less to expenses, etc., which relate to investment income (Section 203 (a) of the 1928 and 1932 Acts). But in addition to those deductions, life insurance companies were given a unique deduction of unusual magnitude, namely, "An amount equal to * * * 4 per centum of the mean of the reserve funds required by law and held at the beginning and end of the taxable year * * *." Section 203 (a) (2) of the 1928 and 1932 Acts.[8]

In essence, therefore, a life insurance company not only escapes taxation on all of its income outside of interest, dividends and rents, but, even after its taxable income is reduced by deductions pertaining thereto, it is still further reduced by a large artificial deduction equal to a percentage of its re-

[8] Under the 1928 and earlier acts the deduction was subject to a certain limitation that was declared unconstitutional in *Nat'l Life Ins. Co.* v. *United States*, 277 U. S. 508, and the limitation was accordingly eliminated from the statute in the 1932 Act. The 1932 Act also reduced the percentage from 4 to 3¾.

serves.[9] The question here presented is whether, in computing that deduction, the petitioner is entitled to augment its life insurance reserves by adding thereto its reserves for health and accident (casualty) insurance which it sells in conjunction with its life insurance. We contend that the extraordinary deduction is limited to reserves pertaining to life insurance, and was not intended to embrace reserves on account of casualty insurance. Casualty insurance companies themselves are taxed under different provisions of the statute, and no such deduction is available to them. It is our position that

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[9] The new method of taxing life insurance companies was first proposed by the Association of Life Insurance Presidents in 1918, but, although approved by the Senate Finance Committee (S. Rep. No. 617, 65th Cong., 3d Sess., p. 9), was not incorporated into the Revenue Act of 1918. See also Cong. Rec., Vol. 57, Pt. I, p. 214. However, the new plan was finally adopted in the Revenue Act of 1921. The House Committee in recommending the new method of taxation stated that "The new tax would yield a larger revenue than the taxes which it is proposed to replace". H. Rep. No. 350, 67th Cong., 1st Sess., p. 14. That the committee was either misled or sadly mistaken is evidenced by the fact that the amount of taxes collected from life insurance companies under the new system has been but a small fraction of what would have been due from them without the artificial deduction on account of reserves. Thus, the Report of the Joint Committee on Internal Revenue Taxation (71st Cong.), Vol. 1, Part 6, p. 15, discloses that during the years 1921–1928 the amount actually due from life insurance companies was probably less than 20% of the taxes which would otherwise have been collectible in the absence of the artificial reserve deduction. And we are informed that in recent years the amount of income taxes paid by life insurance companies has declined even more sharply.

no such deduction should be allowed to a life insurance company merely because it conducts a casualty insurance business as an adjunct to its primary business of life insurance.

2. In determining whether petitioner's casualty reserves constitute "reserve funds required by law" of a life insurance company within the meaning of the deduction provisions in Section 203 (a) (2), it may be helpful to consider first the statutory definition of a life insurance company. Section 201 (a) of the 1928 and 1932 Acts defines a life insurance company as follows:

> (a) *Definition.*—When used in this title the term "life insurance company" means an insurance company engaged in the business of issuing life insurance and annuity contracts (including contracts of combined life, health, and accident insurance), the reserve funds of which held for the fulfillment of such contracts comprise more than 50 per centum of its total reserve funds.

The purpose of the foregoing definition was to classify as life insurance companies those whose business was predominantly life insurance. It was not necessary to define other types of insurance companies because they are sufficiently classified either as "Insurance Companies Other than Life or Mutual" (Sec. 204) or as "Mutual Insurance Companies Other than Life" (Sec. 208).

In applying the definition, it is necessary to determine the correct comparative under Section 201

(a), *i. e.*, what reserves are to be compared with the total reserves in applying the 50 per cent formula? The Government contends that since the purpose of the definition is one of classification the reserves for life insurance and annuity contracts [10] should be compared with the total reserves including the reserves for health and accident insurance.

Any other interpretation of the definition would have practically no meaning, because life insurance companies rarely, if ever, sell any insurance other than life or health and accident insurance. That the attention of Congress was called to the general practice in the insurance world is unmistakably clear from the Senate hearings on the bill which became the Revenue Act of 1921. In the testimony of Dr. T. S. Adams, the Treasury expert who explained the bill to the Committee, the following pertinent colloquy occurred between Senator McCumber and Dr. Adams: [11]

> Senator McCUMBER. Explain that 50 per cent of its total reserve funds, and why take 50 per cent instead of some other figure?
>
> Dr. ADAMS. Some companies mix with their life business accident and health in-

[10] A reserve for annuity contracts is essentially similar to a life insurance reserve. Both are computed on the basis of the same tables, and each complements the other.

[11] Hearings before the Senate Finance Committee on H. R. 8245 (67th Cong., 1st Sess.), p. 85.

> surance. It is not practicable for all companies to disassociate those businesses so that we have assumed that if this accident and health business was more than 50 per cent of their business, as measured by their reserves, it could not be treated as a life insurance company. On the other hand, if their accident and health insurance were incidental and represented less than 50 per cent of their business we treated them as a life insurance company.

Thus it is plain that in applying the 50 per cent formula in Section 201 (a) Congress did not intend health and accident reserves to be merged with life insurance reserves. Health and accident insurance was regarded as separate and distinct from life insurance, and, in determining whether a company was to be classified as a life insurance company, reserves for health and accident insurance were to be excluded.

Nor is there any practical basis for construing the statutory definition as providing for a comparison of (1) the amount of the reserves held for separate policies of life and annuity contracts plus all the reserves held for combined policies of life, health and accident insurance, with (2) the reserves held for separate policies of health and accident insurance. The health and accident (casualty) provisions of a combined policy of life, health and accident insurance are just as separate and distinct in their contractual character from the provisions relating to

life insurance as are contracts of health and accident insurance which are issued in separate policies. Whether issued in separate or combined policies, the reserves for this form of disability insurance are calculated, alike, upon the same tables of probabilities, are set up and maintained separately and apart from reserves for life insurance, and in no manner affect the reserves for life insurance, or enter therein. A net premium is charged for the disability provisions of a combined policy, as distinctly as is done when this kind of insurance is issued in a separate policy. Petitioner's position would result in treating disability insurance as life insurance if written in a combined policy, and as casualty insurance if written in a separate policy, whereas it is the same kind of insurance—that is, casualty insurance—regardless of which kind of policy is issued. This would entirely destroy tthe comparative in the case of a company which issues no separate policies of disability insurance, such as the taxpayer in this case. In the case of a company which issues separate as well as combined policies of casualty insurance, it would operate to array the reserves held on account of disability insurance issued under combined policies against reserves held for the same kind of insurance issued under separate policies, a result that Congress could hardly have intended where it sought to classify companies according to the kind of insurance issued.

We now pass to the deduction provisions in Section 203 (a) (2), which should be interpreted

against the background of the foregoing discussion. For, since the definition of a life insurance company shows that Congress was intent upon granting unusual treatment only to companies whose business was predominantly life insurance, it seems clear that Congress could not have intended the unusual reserve deduction to apply to any but life insurance (including annuity contracts) reserves.

3. Section 203 (a) (2) allows to life insurance companies a deduction of—

> An amount equal to * * * 4 [3¾ under the 1932 Act] per centum of the mean of the reserve funds required by law and held at the beginning and end of the taxable year * * *.

It is our position that, in allowing such an extraordinary deduction to life insurance companies, Congress intended it to apply only to life insurance reserves.

The difference between reserves for life insurance and reserves for health and accident insurance was plainly brought out in the Senate Hearings on the 1921 bill. Senator McCumber had been under a misapprehension that health and accident insurance was to be treated the same as life insurance, and it was in a response to his inquiry that the situation was clarified (Senate Finance Committee Hearings on H. R. 8245, 67th Cong., 1st Sess., p. 85):

> Senator McCumber. If they are treated just alike I do not see any necessity of making any distinction.

> Dr. ADAMS. They are not treated just alike. There is only one deduction that goes under life insurance alone.

Any other treatment would be discriminatory in favor of life insurance companies against casualty insurance companies. No such deduction is allowable to the latter on account of health and accident reserves. It was only because of an asserted inherent difference in the nature of life insurance that life insurance companies were separately classified for tax purposes. And the mere fact that life insurance companies have been so fortunate as to persuade Congress to award them this unusual deduction on account of their life insurance reserves is no reason to believe that Congress intended to extend that deduction to casualty reserves. Indeed, since casualty insurance companies themselves are not entitled to any such deduction with respect to their casualty reserves, Congress could hardly have intended to grant such deduction to life insurance companies simply because they enjoy such unusually favorable treatment with respect to their life insurance reserves.

The decisions of this Court indicate that the reserve deduction given to life insurance companies is to be narrowly restricted to life insurance reserves. Thus, in *Helvering* v. *Inter-Mountain Life Insurance Co.*, 294 U. S. 686, a life insurance company had issued 20-year non-participating life insurance policies to each of which were attached 19

coupons maturing annually and in each of which the company promised to pay a specified amount to the owner of the policy. The insured was given the option of leaving the coupons to accumulate interest or to be applied towards the purchase of additional insurance. Since the company was required by law to maintain reserves on account of such coupons, it sought a deduction with respect thereto. This Court denied the deduction, holding that the reserve deduction was limited strictly to life insurance reserves. The Court said (pp. 689, 690):

> In the reserves required by the laws of Utah and of the other States in which the company issues policies of the described class, there is included an amount sufficient to cover not only all elements of insurance but also the coupon liability. We are not here dealing with reserves in relation to solvency of the company. The thing to be ascertained is the meaning that Congress intended by the language "4 per centum of the mean of the reserve funds required by law." *The clause to be construed relates exclusively to life insurance companies.* It is intended to define a deduction which they are permitted to make in the calculation of the net amount to be taxed. The rule that ambiguities in statutes imposing taxes are to be resolved in favor of taxpayers does not apply. Deductions are allowed only when plainly authorized. * * *

> * * * In life insurance the reserve means the amount, accumulated by the company out of premium payments, which is attributable to and represents the value of the life insurance elements of the policy contracts. * * * [Italics supplied.]

A like result was reached in *Continental Assur. Co.* v. *United States,* 8 F. Supp. 474 (C. Cls.). Cf. *Minnesota Mutual Life Ins. Co.* v. *United States,* 66 C. Cls. 481, certiorari denied, 279 U. S. 856 (reserve for deferred dividends); *Massachusetts Mutual Life Ins. Co.* v. *United States,* 56 F. (2d) 897 (C. Cls.) (reserve for dividends left with company to accumulate interest).

Again in *Helvering* v. *Illinois Ins. Co.,* 299 U. S. 88, this Court held that reserves on account of "survivorship investment funds" growing out of 20-payment life insurance policies were not within the statute. The Court stressed the fact that the deduction is available only with respect to *life insurance* reserves (p. 90):

> The phrase "required by law" includes only reserves that directly pertain to life insurance. Other reserves, even though required by state statutes regulatory of the business authorized to be carried on by life insurance companies, are not included.* * *

Cf. *New York Ins. Co.* v. *Edwards,* 271 U. S. 109.

Moreover, the very structure of Section 203 (a) (2) shows that no deduction was to be allowed on account of such casualty insurance as is here involved. Section 203 (a) (2) provides:

SEC. 203. NET INCOME OF LIFE INSURANCE COMPANIES.

(a) *General rule.*—In the case of a life insurance company the term "net income" means the gross income less—

* * * * *

(2) *Reserve Funds.*—An amount equal to * * * 4 per centum of the mean of the reserve funds required by law and held at the beginning and end of the taxable year, plus (in case of life insurance companies issuing policies covering life, health, and accident insurance combined in one policy issued on the weekly premium payment plan, continuing for life and not subject to cancellation) 4 per centum of the mean of such reserve funds (not required by law) held at the beginning and end of the taxable year, as the Commissioner finds to be necessary for the protection of the holders of such policies only;

The type of insurance mentioned in the long parenthetical provision is commonly known as industrial insurance. The health and accident feature in such policies is inseverable from the life insurance. It is insurance of a very specialized character. And the deduction is allowable only if the many conditions set forth are met. These specific provisions emphasize the basic pattern of the deduction: in general, only life insurance reserves may form the basis for the deduction; any other reserves to be included must be spelled out in detail.

It is clear, we submit, that both the unambiguous intention of Congress and the structure of Section 203 (a) (2) itself forbids the deduction sought by petitioner. But even if there were doubt on the issue, that doubt would have to be resolved against petitioner, for deductions are allowable only when plainly authorized. See *Helvering* v. *Inter-Mountain Life Insurance Co.*, 294 U. S. 686, 689–690; *White* v. *United States*, 305 U. S. 281, 292; *United States* v. *Stewart*, No. 13, present Term, decided November 12, 1940; *Helvering* v. *Northwest Steel Rolling Mills, Inc.*, No. 121, present Term, decided November 12, 1940.

4. We do not understand petitioner to contend that it would be entitled to a deduction on account of reserves for health and accident insurance if it had sold the health and accident insurance separately, apart from its life insurance. Its sole contention appears to be that merely because its health and accident insurance is sold in conjunction with its life insurance it somehow or other partakes of the nature of life insurance for the purpose of the deduction.

But the mere fact that two policies are combined can be of no significance here. They are entirely separate contracts (cf. *New York Life Ins. Co.* v. *United States*, 12 F. (2d) 643 (C. C. A. 2d), certiorari denied, 273 U. S. 712), and the premium for the health and accident provisions is separately shown (R. 66). An examination of the specimen policy (R. 61–68) shows that it is a life insurance

policy complete in itself, and that the health and accident provisions are on a separate sheet (R. 66) which could readily be inserted or omitted without affecting the basic life insurance policy. The health and accident insurance may be discontinued at any time without affecting the life insurance. And the reserves held on account of the health and accident insurance are entirely independent of the life insurance. Those reserves have nothing whatever to do with the reserves on the life insurance policy itself.

The two types of insurance are just as separate and distinct as if written in separate policies. The only reason for combining them physically in a single document is that the company's practice is to sell health and accident insurance only in conjunction with life insurance. But there is nothing inherent in the two types of insurance which requires that practice, for other life insurance companies sell health and accident insurance either independently or in conjunction with life insurance. See, e. g., *Commissioner* v. *Monarch Life Insurance Co.*, 114 F. (2d) 314 (C. C. A. 1st).

To permit the deduction where the health and accident provisions are physically pasted into a life insurance policy while denying the deduction where the health and accident policy is sold in a separate document would seem to be an obvious distortion of Congressional intent.

5. It is to be observed further that petitioner's reserves on account of its health and accident insur-

ance fall into two groups: reserves for "Active Lives" and reserves for "Disabled Lives." (R. 29–30.) The former relate to outstanding policies where disability has not yet occurred, or may never occur. The latter relate to policies where disability has already occurred, and the reserve is intended to meet petitioner's liability throughout the continuance of the disability. Thus, it is apparent that the "Disabled Lives" reserve is more in the nature of a solvency reserve: the event giving rise to liability has occurred and only the extent of the liability is uncertain. Therefore, even if the Government should be wrong in contending broadly that no deductions are available on account of casualty reserves, then, in any event, no deduction should be allowed as to the reserve for "Disabled Lives." The latter reserve is comparable to reserves for liabilities for unsettled loss claims, which are plainly not *insurance* reserves. Cf. *United States* v. *Boston Insurance Co.*, 269 U. S. 197, 203, disapproving *Maryland Casualty Co.* v. *United States*, 251 U. S. 342, 350. See also *McCoach* v. *Insurance Co. of N. Amer.*, 244 U. S. 585, 588–589; *New York Ins. Co.* v. *Edwards*, 271 U. S. 109, 117–119, 119–121.

6. The administrative practice under Section 203 (a) (2) has not been uniform. The Treasury Regulations originally provided [12] for deductions with respect to "Items 7–11 of the liability page of the annual statement for life insurance companies".

[12] See Article 681 of Regulations 62, 65, and 69, and Article 971 (2) of Regulations 74 and 77.

And reference to "Items 7–11" discloses that reserves for health and accident insurance were embraced therein.[13]

However, the Treasury Department had long been in doubt as to the correctness of that ruling, and, encouraged by this Court's decisions in the *Inter-Mountain* and *Illinois Life* cases, it eliminated that ruling in promulgating Regulations 86 under the Revenue Act of 1934. Since those were the first regulations issued under the 1934 Act, and therefore operated prospectively only,[14] it is quite clear that, at least for the year 1934 and thereafter, the Treasury Department was not bound by the earlier practice. Cf. *Helvering* v. *Wilshire Oil Co.*, 308 U. S. 90.

But the tax years in this case are governed by the 1928 and 1932 Acts with respect to which Regulations 86 have no application. Regulations 74 and 77, respectively, contain the rulings applicable to the 1928 and 1932 Acts. And those regulations, as originally promulgated, set forth the earlier practice.[15] It was thus necessary to amend those regulations in order to reflect the change in practice. This was accomplished by T. D. 4615, XIV–2

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[13] See Bulletin "H," Income Tax Rulings peculiar to Insurance Companies, p. 27.

[14] Regulations 86 were formally promulgated February 11, 1935, before the first returns for the year 1934 were due (March 15, 1935). The Revenue Act of 1934 had been enacted May 10, 1934. C. 277, 48 Stat. 680.

[15] See Article 971 (2) of Regulations 74 and 77.

Cum. Bull. 312, approved December 18, 1935. Accordingly, pursuant to T. D. 4615, the regulations under the 1928 and 1932 Acts were specifically amended to eliminate the earlier ruling.

Such a "retroactive" change in the regulations is entirely proper, because the earlier regulations failed to interpret the statute correctly. They were not in harmony with the decisions of this Court which indicated that the words "reserves required by law" meant *life insurance* reserves. And it is well settled that the Treasury may change its practice, even retroactively, where its prior interpretation of the statute is erroneous. See *Manhattan Co.* v. *Commissioner,* 297 U. S. 129, 134–135; *Murphy Oil Co.* v. *Burnet,* 287 U. S. 299. Cf. *Biddle* v. *Commissioner,* 302 U. S. 573, 582; *Koshland* v. *Helvering,* 298 U. S. 441. Indeed, such change is particularly appropriate where it is induced by judicial decision. See *Morrissey* v. *Commissioner,* 296 U. S. 344, 355. Moreover, since the earlier practice was not in harmony with the correct interpretation of the statute, such a change in practice is not forbidden by *Helvering* v. *Reynolds Tobacco Co.,* 306 U. S. 110.

But even if the *Reynolds Tobacco* case is thought to be a bar, we respectfully ask that it be reconsidered. Section 1108 (a) of the Revenue Act of 1926 (c. 27, 44 Stat. 9), as amended by Section 506 of the Revenue Act of 1934, specifically provides that "The Secretary, or the Commissioner with the

approval of the Secretary, may prescribe the extent, *if any,* to which any ruling, regulation, or Treasury Decision, relating to the internal revenue laws, shall be applied without retroactive effect." (Italics supplied.) These provisions plainly contemplate that a ruling or regulation under a revenue act shall affect *all* tax years governed by such act, whether or not they are prior years, *unless* the Secretary of the Treasury determines otherwise. In short, the statute gives the Secretary the power to relax the retroactive operation of ruling in his discretion. And he is presumably to exercise that discretion in the light of possible supervening equities that may have arisen in favor of the taxpayer.

The general rule contemplated by the statute is that any change in the regulations is to operate retrospectively as well as prospectively, but in order to avoid possible hardship, the Secretary is authorized to permit the prior regulation to govern up to the time of change. But the discretion was vested by Congress in the Secretary and not in the courts.

Whether the Secretary has abused his discretion in failing to provide that a new regulation operate prospectively only may be an appropriate subject for judicial review. But we believe that there is no basis for limiting the Secretary's power merely "to correct misinterpretations, inaccuracies, or omissions". (306 U. S. at 116.) Such an inter-

pretation of the Treasury's power under the plain language of the statute is without any support in the legislative history, or otherwise. We respectfully submit that the *Reynolds* decision has unduly limited the power of the Treasury to modify its regulations, and we therefore ask that it be reconsidered if it is thought to forbid the "retroactive" change in practice here.

The history of the revenue acts discloses a progressive endeavor by Congress to lodge complete discretion with the Treasury in determining whether a change in the regulations should operate prospectively only. The first statutory provisions bearing on this question appeared in the Revenue Act of 1921, c. 136, 42 Stat. 227. Section 1314 of that Act provided:

> RETROACTIVE REGULATIONS.
>
> SEC. 1314. That in case a regulation or Treasury decision relating to the internal-revenue laws made by the Commissioner or the Secretary, or by the Commissioner with the approval of the Secretary, is reversed by a subsequent regulation or Treasury decision, and such reversal is not immediately occasioned or required by a decision of a court of competent jurisdiction, such subsequent regulation or Treasury decision may, in the discretion of the Commissioner, with the approval of the Secretary, be applied without retroactive effect.

In commenting upon those provisions (referred to as Sec. 1002 in the House bill), the House Ways and Means Committee stated (H. Rep. No. 350, 67th Cong., 1st Sess., p. 15):

> Section 1002 would permit the Treasury Department to apply without retroactive effect a new regulation or Treasury decision reversing a prior regulation or Treasury decision, unless such reversal is occasioned or required by a decision of a court of competent jurisdiction.

And the Senate Finance Committee similarly remarked (S. Rep. No. 275, 67th Cong., 1st Sess., p. 32):

> Section 1314 of the proposed bill authorizes the commissioner, with the approval of the Secretary, to provide in making a regulation or Treasury decision which reverses a prior regulation or Treasury decision (if it is not immediately occasioned by a decision of a court of competent jurisdiction) that the new regulation or Treasury decision may be applied without retroactive effect.

Thus, it was clear that under the 1921 Act, any change in the regulations was to operate retrospectively as well as prospectively, unless the Treasury determined to permit the change to operate prospectively only. But where the change in regulations was occasioned by judicial decision the Treasury was to have no discretion: such change

was to affect all tax years, both before and after the change.

The next revenue act, the Revenue Act of 1924, c. 234, 43 Stat. 253, made no change in these provisions which were embodied in Section 1008 (a) of that Act. Thereafter, the same provisions were carried over as Section 1108 (a) of the Revenue Act of 1926, without any alteration. However, Section 605 of the Revenue Act of 1928, c. 852, 45 Stat. 791, amended Section 1108 (a) of the 1926 Act as follows:

> SEC. 605. RETROACTIVE REGULATIONS.
>
> Section 1108 (a) of the Revenue Act of 1926 is amended to read as follows:
>
> "SEC. 1108. (a) In case a regulation or Treasury decision relating to the internal-revenue laws is amended by a subsequent regulation or Treasury decision, made by the Secretary or by the Commissioner with the approval of the Secretary, such subsequent regulation or Treasury decision may, with the approval of the Secretary, be applied without retroactive effect.

The purpose of the amendment was to increase further the discretion given to the Treasury. It was intended to permit the Treasury to determine whether a change in regulations should operate prospectively only, even where the change was induced by judicial decision. This was made abundantly clear by the Senate Finance Committee which

stated (S. Rep. No. 960, 70th Cong., 1st Sess., p. 40):[18]

> Section 1108 (a) of the revenue act of 1926 provides that where a regulation or Treasury decision is reversed by a subsequent regulation or Treasury decision, the subsequent decision may be applied without retroactive effect if the reversal is not immediately occasioned or required by a court decision. The policy of this provision is highly desirable, and in view of the fact that the Bureau of Internal Revenue is now comparatively free from the congestion of cases from the war years, it is believed that this policy may now be extended to cases where the new regulation or Treasury decision is occasioned or required by a court decision. Fundamentally there is no difference in the

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[18] In accepting the Senate amendment, the Conference Committee declared (H. Rep. No. 1882, 70th Cong., 1st Sess., p. 22):

> Section 1108 (a) of the revenue act of 1926 permits the commissioner to apply a new regulation or Treasury decision without retroactive effect when the new regulation or Treasury decision is not immediately occasioned by a court decision.
>
> This desirable policy has been extended by the Senate amendment so as to include all regulations and Treasury decisions whether or not occasioned by a court decision. It is hoped that this provision will prevent the constant reopening of cases on account of changes in regulations or Treasury decisions, and it is believed that sound administration properly places upon the Government the responsibility and burden of interpreting the law and of prescribing regulations upon which the taxpayers may rely; and the House recedes.

> two cases which can justify the restrictions in section 1108 (a) of the 1926 Act. Accordingly, these restrictions have been removed in section 605 of the bill. * * *

The final change wrought in these provisions appeared in Section 506 of the Revenue Act of 1934, which amended Section 1108 (a) of the 1926 Act as follows:

> SEC. 506. RETROACTIVITY OF REGULATIONS, RULINGS, ETC.
>
> Section 1108 (a) of the Revenue Act of 1926, as amended, is amended to read as follows:
>
> "(a) The Secretary, or the Commissioner with the approval of the Secretary, may prescribe *the extent, if any,* to which any ruling, regulation, or Treasury Decision, relating to the internal revenue laws, shall be applied without retroactive effect." [Italics supplied.]

The discretion vested in the Treasury was now complete. The Treasury could determine not only whether changes in regulations were to be retrospective in all cases, but it was given the further power of declaring the exact extent of retroactivity. Thus, under the new provisions, the Treasury might provide for a change in regulations that would operate retroactively for any designated period. The committee reports leave no doubt whatever that this was the purpose of these provisions. The House Ways and Means Committee unambiguously explained the amended provisions

as follows (H. Rep. No. 704, 73rd Cong., 2nd Sess., p. 38):

> This section amends section 1108 (a) of the Revenue Act of 1926, as amended, so as to permit the Secretary, or the Commissioner with the approval of the Secretary, to prescribe the extent, if any, to which any regulation, Treasury Decision, or ruling relating to internal revenue taxes shall be applied without retroactive effect. The amendment extends the right granted by existing law to the Treasury Department to give regulations and Treasury Decisions amending prior regulations or Treasury Decisions prospective effect only, by allowing the Secretary, or the Commissioner with the approval of the Secretary, to prescribe the exact extent to which any regulation or Treasury Decision, whether or not it amends a prior regulation or Treasury Decision, will be applied without retroactive effect. The amendment furthermore permits internal revenue rulings as well as regulations or Treasury Decisions to be applied without retroactive effect. *Regulations, Treasury Decisions, and rulings which are merely interpretive of the statute, will normally have a universal application, but in some cases the application of regulations, Treasury Decisions, and rulings to past transactions which have been closed by taxpayers in reliance upon existing practice, will work such inequitable results that it is believed desirable to lodge in the Treasury Department*

> *the power to avoid these results by applying certain regulations, Treasury Decisions, and rulings with prospective effect only.* [Italics supplied.]

A similar statement was made by the Senate Finance Committee. S. Rep. 558, 73rd Cong., 2nd Sess., p. 48.

The history of these provisions plainly shows, we submit, that Congress intended the Treasury to have full and complete discretion to determine to what extent changes in regulations are to operate retroactively. Nowhere in the legislative history is there the slightest suggestion that the Treasury's discretion was to be limited, in the language of the *Reynolds* opinion, merely "to correct misinterpretations, inaccuracies, or omissions." 306 U. S. at 116. The broad sweep of the statutory provisions themselves and the clear and persistent statements appearing in the committee reports afford no support whatever for limitation imposed upon those provisions by the *Reynolds* decision. In the circumstances, we think it peculiarly appropriate to ask the Court to reconsider its decision in the *Reynolds* case.

The statutory scheme, as we construe it, is a wise one. It accords full discretion to the Treasury to decide to what extent, if any, a change in practice is to be retroactive. The Treasury is best situated to determine when just expectations would be defeated by a retroactive application of a new regu-

lation, or when taxpayers are likely to have acted in reliance upon prior practice. And it was the intention of Congress to permit the Treasury to call upon its superior fund of information and experience in fixing the limits of operation of a new regulation.

It should not be assumed that the Treasury will abuse that discretion. Indeed, a recent instance of the Treasury's sense of fairness in applying these provisions may be seen in its action following this Court's decision in *Helvering* v. *Hallock*, 309 U. S. 106. The *Hallock* decision had overruled *Helvering* v. *St. Louis Union Trust Co.*, 296 U. S. 39, and thus invalidated the Treasury regulations that had previously been adopted to reflect the result in the *St. Louis Union Trust Co.* case. But the Treasury recognized that transfers of property may have been made between the date of the *St. Louis Union Trust Co.* decision (1935) and the *Hallock* decision in reliance upon those regulations. Accordingly, in promulgating amended regulations to reflect the result of the *Hallock* decision the Treasury has specifically provided that all transfers made during the period between the *St. Louis Union Trust Co.* and *Hallock* decisions are to be governed by the rule of the existing rather than the new regulations. T. D. 5008, promulgated September 19, 1940.

In the instant case, the Treasury apparently felt that there was no occasion to limit the retroactive operation of the regulations. The issue on the merits related to the method of computing reserves.

There was little, if any, likelihood that the prior regulations had induced a course of conduct or other reliance by the insurance companies. It is highly improbable that insurance companies would have conducted their business differently in the absence of such prior regulations. In the circumstances, it was entirely within the Treasury's discretion to conclude that there was no occasion to allow a windfall to the insurance companies by perpetuating a prior erroneous interpretation of the statute; and since the old interpretation probably had not induced a course of conduct, there was no reason to permit the old interpretation to govern pending cases. And to the extent that equities may be thought to arise simply from the passing of time, the Treasury apparently felt that the insurance companies were sufficiently protected by the statute of limitations. Certainly, there was nothing in the Treasury's exercise of discretion here that could be labeled as arbitrary.

We respectfully submit that under Section 1108 (a), as amended by Section 506 of the 1934 Act, the Treasury had full and complete power to amend its regulations with or without retroactive effect; that it amended its regulations here retroactively; that there was reasonable ground for it to believe that it was not defeating any just expectations in so doing; and that there has been no abuse in discretion by the Treasury. To the extent that the *Reynolds* decision indicates that the Treasury was

without power so to act, we respectfully submit that it was incorrectly decided. But, in any event, the *Reynolds* decision is not a bar here because the early regulations in this case were not in harmony with decisions of this Court construing the meaning of "reserves required by law" in relation to life insurance companies.

CONCLUSION

The reserve deduction issue is not properly before this Court. Since the judgment of the court below could not be affected regardless of how the reserve issue might be decided here, the writ should be dismissed.

But if the Court should conclude that the issue is properly here and should undertake to "declare rights", then the deduction for health and accident reserves claimed by petitioner was not allowable.

Respectfully submitted.

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NOVEMBER 1940.

APPENDIX

Revenue Act of 1928, c. 852, 45 Stat. 791:

SEC. 201. TAX ON LIFE INSURANCE COMPANIES.

(a) *Definition.*—When used in this title the term "life insurance company" means an insurance company engaged in the business of issuing life insurance and annuity contracts (including contracts of combined life, health, and accident insurance), the reserve funds of which held for the fulfillment of such contracts comprise more than 50 per centum of its total reserve funds.

* * * * *

SEC. 202. GROSS INCOME OF LIFE INSURANCE COMPANIES.

(a) In the case of a life insurance company the term "gross income" means the gross amount of income received during the taxable year from interest, dividends, and rents.

* * * * *

SEC. 203. NET INCOME OF LIFE INSURANCE COMPANIES.

(a) *General rule.*—In the case of a life insurance company the term "net income" means the gross income less—

* * * * *

(2) RESERVE FUNDS.—An amount equal to * * *[1] 4 per centum of the mean of the re-

[1] The language omitted contains a limitation upon the deduction that was declared unconstitutional in *Nat'l Life Ins. Co.* v. *United States*, 277 U. S. 508, and was eliminated in all later revenue acts.

serve funds required by law and held at the beginning and end of the taxable year, plus (in case of life insurance companies issuing policies covering life, health, and accident insurance combined in one policy issued on the weekly premium payment plan, continuing for life and not subject to cancellation) 4 per centum of the mean of such reserve funds (not required by law) held at the beginning and end of the taxable year, as the Commissioner finds to be necessary for the protection of the holders of such policies only;

* * * * *

The corresponding provisions of the Revenue Act of 1932, c. 209, 47 Stat. 169, are identical with the foregoing, except that subdivision (2) of Section 203 (a) provides for the use of a rate of 3¾ per centum of the mean of the reserve funds instead of 4 per centum in a case where the reserve funds are computed at an interest assumption rate lower than 4 per centum.

SEC. 204. INSURANCE COMPANIES OTHER THAN LIFE OR MUTUAL.

* * * * *

(b) *Definition of income, etc.*—In the case of an insurance company subject to the tax imposed by this section—

(1) GROSS INCOME.—"Gross income" means the sum of (A) the combined gross amount earned during the taxable year, from investment income and from underwriting income as provided in this subsection, computed on the basis of the underwriting and investment exhibit of the annual statement approved by the National Convention of Insurance Commissioners, and (B) gain

during the taxable year from the sale or other disposition of property;

(2) NET INCOME.—"Net income" means the gross income as defined in paragraph (1) of this subsection less the deductions allowed by subsection (c) of this section;

(3) INVESTMENT INCOME.—"Investment income" means the gross amount of income earned during the taxable year from interest, dividends, and rents, computed as follows:

To all interest, dividends and rents received during the taxable year, add interest, dividends and rents due and accrued at the end of the taxable year, and deduct all interest, dividends and rents due and accrued at the end of the preceding taxable year;

(4) UNDERWRITING INCOME.—"Underwriting income" means the premiums earned on insurance contracts during the taxable year less losses incurred and expenses incurred;

(5) PREMIUMS EARNED.—"Premiums earned on insurance contracts during the taxable year" means an amount computed as follows:

From the amount of gross premiums written on insurance contracts during the taxable year, deduct return premiums and premiums paid for reinsurance. To the result so obtained add unearned premiums on outstanding business at the end of the preceding taxable year and deduct unearned premiums on outstanding business at the end of the taxable year;

(6) LOSSES INCURRED.—"Losses incurred" means losses incurred during the taxable year on insurance contracts, computed as follows:

To losses paid during the taxable year, add salvage and reinsurance recoverable outstanding at the end of the preceding taxable year, and deduct salvage and reinsurance recoverable outstanding at the end of the taxable year. To the result so obtained add all unpaid losses outstanding at the end of the taxable year and deduct unpaid losses outstanding at the end of the preceding taxable year;

(7) EXPENSES INCURRED.—"Expenses incurred" means all expenses shown on the annual statement approved by the National Convention of Insurance Commissioners, and shall be computed as follows:

To all expenses paid during the taxable year add expenses unpaid at the end of the taxable year and deduct expenses unpaid at the end of the preceding taxable year. For the purpose of computing the net income subject to the tax imposed by this section there shall be deducted from expenses incurred as defined in this paragraph all expenses incurred which are not allowed as deductions by subsection (c) of this section.

(c) *Deductions allowed.*—In computing the net income of an insurance company subject to the tax imposed by this section there shall be allowed as deductions:

(1) All ordinary and necessary expenses incurred, as provided in section 23 (a);

(2) All interest as provided in section 23 (b);

(3) Taxes as provided in section 23 (c);

(4) Losses incurred as defined in subsection (b) (6) of this section;

(5) Losses sustained during the taxable year from the sale or other disposition of property;

(6) Bad debts in the nature of agency balances and bills receivable ascertained to be worthless and charged off within the taxable year;

(7) The amount received as dividends from corporations as provided in section 23 (p);

(8) The amount of interest earned during the taxable year which under section 22 (b) (4) is exempt from taxation under this title, and the amount of interest allowed as a credit under section 26;

(9) A reasonable allowance for the exhaustion, wear and tear of property, as provided in section 23 (k);

(10) In the case of such a domestic insurance company, the net income of which (computed without the benefit of this paragraph) is $25,000 or less, the sum of $3,000; but if the net income is more than $25,000 the tax imposed by this section shall not exceed the tax which would be payable if the $3,000 credit were allowed, plus the amount of the net income in excess of $25,000.

SEC. 208. MUTUAL INSURANCE COMPANIES OTHER THAN LIFE.

(a) *Application of title.*—Mutual insurance companies, other than life insurance companies, shall be taxable in the same manner as other corporations, except as hereinafter provided in this section.

(b) *Gross income.*—Mutual marine-insurance companies shall include in gross income the gross premiums collected and received by them less amounts paid for reinsurance.

(c) *Deductions.*—In addition to the deductions allowed to corporations by section 23 the following deductions to insurance companies shall also be allowed, unless otherwise allowed—

(1) MUTUAL INSURANCE COMPANIES OTHER THAN LIFE INSURANCE.—In the case of mutual insurance companies other than life insurance companies—

(A) the net addition required by law to be made within the taxable year to reserve funds (including in the case of assessment insurance companies the actual deposit of sums with State or Territorial officers pursuant to law as additions to guarantee or reserve funds); and

(B) the sums other than dividends paid within the taxable year on policy and annuity contracts.

(2) MUTUAL MARINE INSURANCE COMPANIES.—In the case of mutual marine insurance companies, in addition to the deductions allowed in paragraph (1) of this subsection, unless otherwise allowed, amounts repaid to policyholders on account of premiums previously paid by them, and interest paid upon such amounts between the ascertainment and the payment thereof;

(3) MUTUAL INSURANCE COMPANIES OTHER THAN LIFE AND MARINE.—In the case of mutual insurance companies (including interinsurers and reciprocal underwriters, but not including mutual life or mutual marine insurance companies) requiring their members to make premium deposits to provide for losses and expenses, the amount of premium deposits returned to their policyholders and the amount of premium deposits retained for the payment of losses, expenses, and reinsurance reserves.

Article 971 of Regulations 77 (promulgated under Revenue Act of 1932), as amended by T. D. 4615, XIV-2 Cum. Bull. 312, issued December 18, 1935:

> ART. 971. *Tax-exempt interest and reserve funds.*—Under paragraphs (1) and (2) of section 203 (a), life insurance companies are entitled to deduct from gross income:
>
> * * * * *
>
> (2) Four percent of the mean of the reserve funds required by law and held at the beginning and end of the taxable year, except that in the case of any such reserve fund which is computed at a lower interest assumption rate, the rate of 3¾ percent shall be substituted for 4 percent.
>
> In general, the reserve contemplated is a sum of money, variously computed or estimated, which, with accretions from interest, is set aside (reserved) as a fund with which to mature or liquidate, either by payment or reinsurance with other companies, future unaccrued and contingent claims. It must be required either by express statutory provisions or by rules and regulations of the insurance department of a State, Territory, or the District of Columbia when promulgated in the exercise of a power conferred by statute, but such requirement, without more, is not conclusive; for example, it does not include reserves required to be maintained to provide for the ordinary running expenses of a business definite in amount, and which must be currently paid by every company from its income if its business is to continue, such as taxes, salaries, reinsurance, and unpaid brokerage; the reserve or net value of risks reinsured in other solvent companies to the extent of the reinsurance; reserve for premiums paid in advance; an-

nual and deferred dividends; accrued but unsettled policy claims; losses incurred but unreported; liability on supplementary contracts not involving life contingencies; estimated value of future premiums which have been waived on policies after proof of total and permanent disability.

In any case where reserves are claimed, sufficient information must be filed with the return to enable the Commissioner to determine the validity of the claim. Reference should be made to the item in which the reserve appears in the annual statement and to the statute or insurance department ruling requiring that such reserves be held. Only reserves which are so required, which are peculiar to insurance companies, and which are dependent upon interest earnings for their maintenance will be considered. A company is permitted to make use of the highest aggregate reserve called for by any State or Territory or the District of Columbia in which it transacts business, but the reserve must have been actually held.

* * * * *

Prior to amendment, Article 971 of Regulations 77, *supra*, read as follows:

ART. 971. *Tax-exempt interest and reserve funds.*—Under paragraphs (1) and (2) of section 203 (a), life insurance companies are entitled to deduct from gross income:

* * * * *

(2) Four percent of the mean of the reserve funds required by law and held at the beginning and end of the taxable year, except that in the case of any such reserve fund which is computed at a lower interest assumption rate, the rate of 3¾ percent shall be substituted for 4 percent. The re-

serve deduction is based upon the reserves required by express statutory provisions or by the rules and regulations of the State insurance departments when promulgated in the exercise of a power conferred by statute; but such reserves do not include assets required to be held for the ordinary running expenses of the business nor do they include the reserve or net value of risks reinsured in other solvent companies to the extent of the reinsurance.

* * * Reserves maintained to provide for the ordinary running expenses of a business, definite in amount, and which must be currently paid by every company from its income if its business is to continue, such as taxes, salaries, reinsurance, and unpaid brokerage will not be considered. A company is permitted to make use of the highest aggregate reserve called for by any State in which it transacts business, but the reserve must have been actually held as shown by the annual statement. Generally speaking, the following will be considered reserves as contemplated by the law: Items 7–11 of the liability page of the annual statement for life insurance companies, and items 16–19 and 26 of the liability page of the annual statement for miscellaneous stock companies, if a life insurance company is also transacting other kinds of insurance business. If other reserves are claimed, sufficient information must be filed with the return to enable the Commissioner to determine the validity of the claim. Reference should be made to the item in which the reserve appears in the annual statement and to the State statute or insurance department ruling requiring that such reserves be held. Only reserves which are so required, which

are peculiar to insurance companies, and which are dependent upon interest earnings for their maintenance will be considered.

Article 971 of Regulations 74 (promulgated under the Revenue Act of 1928) originally was substantially in accord with Article 971 of Regulations 77, but was amended by T. D. 4615, *supra,* to comport with the change in Regulations 77.

Pierce's Code (1929), Vol. 1—Washington General Statutes:

> § 2990.—*Insurance Classified.* § 83. All insurance business in this state is hereby classified as follows:
>
> (1) Fire and marine insurance, * * *; but not upon ocean marine risks, and other casualty insurance risks.
>
> (2) Marine insurance, being ocean and inland risks, * * * but not including any other casualty insurance as hereinafter provided.
>
> (3) Life insurance, being [including] endowments and annuities, but not including health, or accident or sickness insurance or any other casualty insurance as hereinafter provided.
>
> (4) Accident insurance, and either sickness or health insurance being insurance against injury, disablement, or death resulting from travel or general accident, and against disablement resulting from sickness; and every insurance appertaining thereto.
>
> * * * * *
>
> (6) Liability insurance, being all insurance against loss or damage resulting from accident to or injury, fatal or non-fatal, suffered by an employe or other person and for which the insurer is liable.
>
> * * * * *

§ 2991. *Insurance Permitted.* § 84.

* * * * *

Life. (3) No stock company shall make insurance in this state under class three of section 83 without having a capital stock fully paid of at least one hundred thousand dollars ($100,000.00) * * *, nor shall such company make insurance in this state in any other of said classes of insurance except in classes four and six; * * *.

* * * * *

§ 2999. *Life—Legal Reserve.* § 92. The commissioner shall annually make valuation of all outstanding policies, additions thereto, unpaid dividends, and all other obligations of every life insurance company doing business in this state; * * *: *Provided further,* That no such standard of valuation * * * shall be less than that determined upon such basis according to the American Experience Table of Mortality with three and one-half per centum interest * * *.

The legal minimum standard for the valuation of annuities issued after January first, nineteen hundred and twelve, shall be "McClintock's Table of Mortality Among Annuitants," or the American Experience Table of Mortality, with interest at three and one-half per centum per annum, * * *.

§ 3001. *Health—Reserve.* § 94. The commissioner shall annually make valuations of all outstanding policies of every company insuring against disablement by sickness, on the net premium basis, according to the "British Friendly Society Tables", eighteen hundred and eighty, or the "Manchester Unity Friendly Society Tables," eighteen hundred and ninety-three to eighteen hun-

dred and ninety-seven, with interest at three and one-half per centum per annum. He may, in his discretion, vary the standard in particular cases, * * *.

Extract from Hearings before the Committee on Finance (Senate), 67th Cong., 1st Sess., on H. R. 8245 (Statement of Dr. T. S. Adams), p. 85:

Dr. ADAMS. Section 242, line 6, page 93:

* * * * *

"That when used in this title the term 'life insurance company' means an insurance company engaged in the business of issuing life insurance and annuity contracts (including contract of combined life, health, and accident insurance), the reserve funds of which held for the fulfillment of such contracts comprise more than 50 percent of its total reserve funds."

Senator MCCUMBER. Explain that 50 percent of its total reserve funds, and why take 50 percent instead of some other figure?

Dr. ADAMS. Some companies mix with their life business accident and health insurance. It is not practicable for all companies to disassociate those businesses so that we have assumed that if this accident and health business was more than 50 per cent of their business, as measured by their reserves, it could not be treated as a life insurance company. On the other hand, if their accident and health insurance were incidental and represented less than 50 per cent of their business we treated them as a life insurance company.

Senator MCCUMBER. Suppose that you have those companies in which a certain portion of their business is life insurance and other casualty of any kind, and you have two systems of levying taxes?

Dr. ADAMS. You do not under the House Bill.

Senator MCCUMBER. How do you levy the tax under the two kinds of business in the hands of one company?

Dr. ADAMS. You do not under the House Bill. You did originally under the original suggestion of the Treasury Department, but the House bill now treats them all alike.

Senator DILLINGHAM. In other words, unless a company has a reserve of over 50 per cent on life insurance and annuity contracts it is not a life insurance company?

Dr. ADAMS. No; and it is not very important any more, as you will see. It has only one small application.

Senator MCCUMBER. If they are treated just alike I do not see any necessity of making any distinction.

Dr. ADAMS. They are not treated just alike. There is only one deduction that goes under life insurance alone.

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